<u>Editor's note</u>: 96 I.D. 127, Reconsideration denied by Order dated Oct. 30, 1989

PETRO-LEWIS CORP.

IBLA 86-1566 Decided March 20, 1989

Appeal from a decision of the Director, Minerals Management Service, affirming assessment of royalty on crude oil used to fuel cogeneration facility. MMS 85-01220-O&G.

Affirmed in part; reversed and remanded in part.

1. Mineral Leasing Act: Royalties--Minerals Management Service: Generally--Oil and Gas Leases: Royalties--Oil and Gas Leases: Unit or Cooperative Agreement

Under 30 U.S.C. | 226(b)(1) (1982), royalty is properly assessed on the amount of crude oil used to generate electricity in a cogeneration facility, where that electricity is the subject of a sale to a third party, even if the same electricity is subsequently repurchased and used for beneficial purposes on the lease.

2. Mineral Leasing Act: Royalties--Minerals Management Service: Generally--Oil and Gas Leases: Royalties--Oil and Gas Leases: Unit or Cooperative Agreement

Where royalty is due on crude oil which is utilized to produce electricity, the proper method of valuation for purposes of determining the amount of royalty due is the value of the crude oil had it been sold.

APPEARANCES: Carleton L. Ekberg, Esq., Denver, Colorado, for appellant; Peter J. Schaumberg, Esq., and Douglas O. Bowman, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE BURSKI

The Petro-Lewis Corporation (Petro-Lewis) has appealed from a decision of the Director, Minerals Management Service (MMS), dated May 22, 1986, affirming the assessment of royalty on a portion of the crude oil used to fuel appellant's cogeneration facility 1/ located within the North Kern Front Field Unit in Kern County, California.

The North Kern Front Field Unit (No. 14-08-0001-19647), covering approximately 960 acres, was formed in 1982 to facilitate the operation of a steam injection program for enhanced recovery of low gravity crude oil. Appellant burns crude oil recovered from the unitized formations to produce steam, which is then injected into the producing unitized formations. A portion of the steam passes through an in-line turbine generator to produce electricity. This electricity is both produced and actually used on the unit. Because appellant's unit operations consume more electric power than this cogeneration process produces, appellant purchases additional electric power from Pacific Gas and Electric Company (PG&E).

1/ The regulations define "[c]ogeneration facility" as "equipment used to produce electric energy and forms of useful thermal energy (such as heat or steam), used for industrial, commercial, heating, or cooling purposes, through the sequential use of energy." 18 CFR 292.202(c).

Pursuant to the Public Utility Regulatory Policies Act of 1978, 16 U.S.C. | 2601 (1982), appellant and PG&E entered into a contract relat-ing to the electricity produced by the cogeneration facility. PG&E offered Petro-Lewis two different options: the net energy output option and the surplus energy output option. Under the net energy output option, all electricity would be purchased by PG&E and then resold to Petro-Lewis together with any additional electricity that might be needed for unit operations. Under the surplus energy output option, on the other hand, none of the electricity which Petro-Lewis generated would be sold to PG&E unless it was surplus to Petro-Lewis' needs. If Petro-Lewis failed to produce enough electricity for unit operations, it would purchase so much as was needed from PG&E.

Petro-Lewis originally elected the net energy output option when it executed its agreement with PG&E on April 9, 1985, with an effective date of June 12, 1984. Its choice was dictated by the fact that, at that time, there was a favorable price differential between the higher "avoided costs of power" rates at which PG&E purchased the energy produced by appellant and the lower "industrial" rates which were charged appellant when it repurchased the electricity which it produced and any additional amounts which were needed for unit operations. 2/ Thus, so long as the price differen-tial remained in effect, Petro-Lewis would make a profit on each kWh sold

2/ Appellant also noted that there was a convenience factor in its election. Thus, it was argued that the net energy sale option "met with PG&E's wishes as it provided them time to study prior arrangements made to supply power to our lease plus it provided us a financial incentive, as avoided costs at the time were slightly higher than the industrial power rates" (Letter dated Nov. 11, 1985, from Petro-Lewis cogeneration consultant to Chief, Royalty Valuation and Standards Division, MMS).

and then repurchased, dependent upon the amount of the differential between the two rates. This arrangement continued from February 1984 through March 1986, at which point in time Petro-Lewis switched to the surplus energy output option. 3/

On June 27, 1985, the Chief, Royalty Valuation and Standards Division of the MMS Royalty Management Program (RMP), sent appellant a letter informing it of his determination that royalty was due on the crude oil allocable to the production of the electric power appellant sold to PG&E. This determination was premised on the application of 30 CFR 206.103 which required the payment of royalty on the gross proceeds accruing to the lessee. For royalty purposes, MMS decided to use a "netback" procedure to value the oil used to generate electricity.

Petro-Lewis appealed this determination to the Director, MMS, pursuant to 30 CFR Part 290. In its statement of reasons, Petro-Lewis reiterated the fact that, even though it sold the cogenerated power to PG&E, all of the power which was generated was actually used on the lease for unit operations. Petro-Lewis argued that "the gross proceeds calculation should be based on the difference between the rate received from PG&E less the rate charged by them as multiplied by the period kw-hrs generated by the cogeneration facility," i.e., the price differential between the "avoided cost" rate and the "industrial" rate. Moreover, appellant further argued that

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3/ In May 1985, appellant decided that sale and repurchase of the cogenerated electricity had lost its economic advantage and changed to a surplus energy contract as of the next anniversary date of the contract, i.e., effective Apr. 9, 1986.

no royalty should be assessed on electricity which, while sold, was nevertheless used on lease.

By decision dated May 22, 1986, the Director, MMS, denied the appeal. After briefly reviewing the arrangement between appellant and PG&E, he concluded that the RMP correctly recognized the transaction as a sale subject to royalty, even though the electricity appellant produced never left the unit. The fact that the electricity was sold to PG&E was a critical factor in the Director's decision. Thus, he noted:

> The record suggests that the crude oil burned in the cogeneration facility to produce electric power for enhanced recovery operations is being consumed for a "beneficial purpose" in operating the unit. Ordinarily, no royalty would be assessed on lease production used for these purposes.
>
> In this case, however, Petro-Lewis has elected for its own purposes to sell the electricity it produces from the cogenera-tion facility to PG&E. While it may be true that the power sold and repurchased never leaves the unit, the RMP is correct in recognizing the transaction as a sale. One consequence of the "net energy" arrangement selected by Petro-Lewis is that royalty is payable on the sale. The valuation procedure is affirmed in all respects.

(Decision at 3). Petro-Lewis has timely pursued an appeal of this determination to the Board.

In its appeal, Petro-Lewis makes two basic arguments. First, it contends that the oil used to generate steam and produce electricity used for unit operations is exempt from royalty payments. Second, it argues that, even if it is determined that such oil is not completely exempt from royalties, the Department should look at the entire transaction and the valuation placed on the oil should be modified accordingly. We will discuss these two contentions in order.

[1] The thrust of appellant's first contention is that, to the extent that the individual lease terms have been modified by the unit agreement,

no royalty is owing for oil used to generate steam and to produce electricity used in the unit operations. Appellant's argument proceeds as follows. Under section 17(j) of the Mineral Leasing Act, 30 U.S.C. | 226(j) (1982), the Secretary of the Interior is authorized to establish, alter, or change royalty requirements set forth in oil and gas leases as he deems proper in connection with the institution and operation of a unit plan of development. Pursuant to this authority, the Secretary, acting through the United States Geological Survey, had approved the North Kern Front Field Unit Agreement with the express provision that "drilling, producing, rental, minimum royalty and royalty requirements of all Federal leases committed to said agreement are hereby established, altered, changed, or revoked to conform with the terms of [the unit] agreement." Appellant contends that, under the applicable provisions of the unit agreement, no royalty is properly assessed for cogenerated electricity used on the lease to enhance unit operations, regardless of whether or not this electricity is sold.

The key to appellant's position lies in the interpretation and application of Article 16 of the unit agreement. That Article, entitled "Use or Loss of Unitized Substances," provides as follows:

16.1 Use of Unitized Substances. Unit Operator may use as much of the Unitized Substances as it deems necessary for Unit Operations, including but not limited to the injection thereof into the Unitized Formations.

16.2 Royalty Payment. No royalty, overriding royalty, production or other payments shall be payable upon or with respect to Unitized Substances used or consumed in Unit Operations, or which otherwise may be lost or consumed in the production, handling, treating, transportation or storing of Unitized Substances.

16.3 Substitute Power and Substances. If Unit Operator substitutes fuel or power from an outside source for fuel or power obtainable from Unitized Substances, the amount of Unitized Substances so produced and delivered to Working Interest Owners which would otherwise have been used for fuel or power shall (subject to the express provisions of any particular lease) be free of royalty or other payment, as provided in Section 16.2 above, the same as if this amount of Unitized Substances had been used in Unit Operations.

16.4 Exception. The provisions of Sections 16.2 and 16.3 of this Article 16 shall be inapplicable with respect to royalty payable to the United States to the extent that the application of such provisions would be in conflict with statutes and/or valid regulations issued pursuant thereto.

Appellant posits two different theories as to why it is not properly assessed royalty on the crude oil used to produce the cogenerated electricity. First, it argues that under Article 16.2, all unitized substances used or consumed in production are exempt from royalty payments. Since the electricity produced by the steam is actually totally consumed on the lease, appellant argues that no royalty is properly assessed.

Recognizing that under MMS' sale and purchase analysis Article 16.2 might be judged inapplicable since the cogenerated electricity could be deemed to have been sold to PG&E with an equivalent amount being repurchased, appellant alternatively argues that Article 16.3 would clearly exempt the crude oil used to generate the electricity from royalty assessment.

It seems clear that, if these two sections of Article 16 of the unit agreement are applicable, either would require a reversal of the MMS Director's decision. Thus, the major part of the disagreement in the instant case revolves around Article 16.4. As noted above, that Article provides that sections 16.2 and 16.3 are inapplicable with respect to the royalty interest of the United States "to the extent that the application of such provisions would be in conflict with statutes and/or valid regulations issued pursuant thereto."

MMS essentially argues that both section 16.2 and 16.3 are inappli-cable to the extent that they conflict with 30 U.S.C. | 226(b)(1) (1982), and 30 CFR 202.150(b) and 206.103. Thus, MMS notes that 30 U.S.C. | 226(b)(1) (1982) provides that royalty must be paid on all production "removed or sold from the lease." Since, under the clear terms of the net energy output option Petro-Lewis accepted, the electricity was sold to PG&E, MMS argues that the statute affirmatively requires payment of royalty for the crude oil used to produce the electricity. MMS also notes the 30 CFR 206.103 requirement that, in computing royalty, the value of production shall not be deemed to be less than the gross proceeds accruing to the lessee. MMS contends that, because Petro-Lewis obtained gross proceeds
from the sale of the electricity to PG&E (based on the "avoided costs" rate), the assessment of royalty on the crude oil used to produce the electricity is required by the regulations.

Appellant disputes this interpretation. In support of its position, appellant adverts to the history surrounding Notice to Lessees 4 (NTL-4). While we agree that this history is germane to the issue before the Board, we conclude, for reasons elucidated below, that a correct analysis of both the promulgation and ultimate judicial rejection of NTL-4, supports the conclusion of the Director, MMS, that royalty was properly assessed in the instant case.

NTL-4 was originally promulgated on November 15, 1974, with an effective date of December 1, 1974. In substance, this notice provided that,

as of its effective date, royalty would be payable on the oil used for production purposes on a lease or unit as well as the oil lost in well tests, spills, blowouts and fires which occurred on a lease or unit, regardless of whether such loss might be deemed to be unavoidable. When the Department attempted to implement these changes, however, numerous oil companies challenged the authority of the Secretary to promulgate the new rules.

The Department's attempts to justify these provisions met with a notable lack of success in the Federal courts. Thus, in Marathon Oil Co. v. Andrus, 452 F. Supp. 548 (D. Wyo. 1978), the Wyoming District Court held that the Department's contemporaneous construction of both the original language of section 17 of the Mineral Leasing Act and the 1946 amendments

to the effect that royalties were not to be collected on oil and gas unavoidably lost or used in lease operations, was entitled to great weight, particularly in light of subsequent congressional ratification of that interpretation. Accordingly, the court struck down the conflicting provisions of NTL-4 as arbitrary, capricious, and an abuse of discretion.

Of more particular relevance to the instant appeal was the decision by the District Court for the Central District of California in Gulf Oil Corp. v. Andrus, 460 F. Supp. 15 (C.D. Cal. 1978), which, while it reached the same conclusion as the court in Marathon, used a different line of analysis. While the Marathon court had made an analysis of contemporaneous construction, the Gulf court examined the legislative history of the 1946 amendments to section 17 of the Mineral Leasing Act. Prior to 1946, the relevant language of section 17 had provided for a royalty of not less than 12-1/2 per centum "in the amount or value of the production." In 1946, this language was amended to read "in amount or value of production removed or sold from the lease." Act of August 8, 1946, 60 Stat. 951, as amended, 30 U.S.C. | 226(b)(1) (1982) (emphasis added).

In construing the language added by the 1946 amendments, the court referred to legislative history which had apparently been overlooked by the Department when it promulgated NTL-4. 4/ Because of its ultimate relevance

4/ Thus, NTL-4 was premised on a legal analysis provided by the Solicitor and then approved by Secretary Kleppe. See M-36888 (Oct. 4, 1976). Therein, the Solicitor advised the Secretary,

"We can find no explanation for the addition of the phrase 'removed or sold from the lease.' S. 1236 was first introduced in the 79th Congress, 1st Session. That draft repeated the language of the original section 14 of the Mineral Leasing Act, and referred to 12-1/2 percent in 'amount or value of the production.' Section 2, S. 1236, July 6, 1945. On May 29, 1946, S. 1236 was reported from committee. Without explanation, section 2 of the earlier version, now section 3, was amended to read as eventually passed, '12 1/2 per centum in amount or value of the production removed or sold from the lease.' We have found no explanation of this change in the committee report, the conference debates, or correspondence."

M-36888 at 7-8. But see discussion in text, infra.

to the disposition of the instant appeal, we set out the court's discussion in toto:

> In determining this critical issue, the court must first decide what Congress intended by the 1946 amendment to Section 17. Although legislative history on the amendment is scanty, plaintiff has uncovered the following remarks made by C. P. Watson, Vice-President of Seaboard Oil Corporation, on August 30, 1945, during Senate Subcommittee hearings on the bill that amended the Mineral Leasing Act (S. 1236):
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>> For years the Government, under regulations of the Interior Department, has been computing royalty on the basis of sales, or, as we in the industry say, on the "run tickets." Recently, I have been advised that the Interior Department is going to change that practice; that from now on Government lessees must account for and pay royalty not on the basis of the oil and gas removed from the lease, but on the basis of the production at the well."
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> Hearings on S.1236 Before the Subcommittee of the Senate Commit-tee on Public Lands and Surveys, 79th Cong., 1st Sess., at 160. Mr. Watson then proposed an amendment to prevent the contemplated change in assessing royalty payments:
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>> I would suggest for your consideration, therefore, the addition of the words "removed or sold from said lease" after the word "production" . . .
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> Id. Watson's suggested language was adopted by Congress verbatim. This is persuasive evidence that in enacting the 1946 amendment to Section 17 Congress intended to ensure that royalty would be due only on oil and gas "removed" from the leasehold, not on total oil and gas produced at the well. Since oil and gas used for production purposes on the leasehold where they were initially produced are clearly not "removed" from that leasehold, no royalty should be required by Section 17. [Footnote omitted.]

460 F. Supp. at 17.

Appellant points to the last part of the discussion wherein the Court declared that royalty would be due "only on oil and gas 'removed' from the leasehold" in support of its contention that, since none of the electricity was removed from the leasehold, no royalty was due regardless of whether or not the electricity was "sold." We do not believe that such an interpretation is sustainable when read in the context of the court's decision or in light of Watson's testimony.

The thrust of appellant's argument would require us to ignore the word "sold" in the statutory language. The difficulty with this approach, besides the obvious problem of just striking the word, is that Watson's testimony was to the effect that the Department was about to abandon its past practice of computing royalty on sales in favor of a new approach, which looked merely to production. Watson's proposal was clearly one designed to maintain the status quo, which, as he testified, was one in which royalty was assessed when the product was sold.

Similarly, appellant places far too much weight on the court's discussion relating to the removal of oil and gas from the lease. There is no indication from the court's statement of facts that the crude oil was sold in the Gulf case, nor was there any hint that the Department was attempting to assess royalty based upon a sale of the crude. Rather, consistent with NTL-4, the Department was attempting to assess a royalty on oil produced and used in the production processes. In the absence of any allegation of a sale, the critical statutory language was the word "removed," since under 30 U.S.C. | 226(b) (1982) royalty could only be assessed for oil "removed or sold" from the lease. The fact that the court's decision was focused on this question can scarcely be said to support the conclusion that a sale of the oil would not trigger the statutory requirement that royalty be assessed, independent of any issue as to whether the oil was removed.

Subsequent to the judicial rejection of NTL-4, the Department abandoned its efforts to assess royalty on oil used in production or unavoidably lost. Effective January 1, 1980, the Department adopted NTL-4A. See 44 FR 76600 (Dec. 27, 1979). The relevant language of NTL-4A provides:

> Oil production subject to royalty shall include that which (1) is produced and sold on a lease basis or for the benefit of a lease under the terms of an approved communitization or unitization agreement and (2) the Supervisor determines to have been avoidably lost on a lease, communitized tract, or unitized area. No royalty obligation shall accrue as to that produced oil which (1) is used on the same lease, same communitized tract, or same unitized participating area for beneficial purposes or (2) the Supervisor determines to have been unavoidably lost.

It is clear from the context of the litigation which led to this amendment that the dichotomy being drawn in NTL-4A was between oil "produced and sold" and oil which was "produced * * * [and] used on the same lease." Nothing in this regulation could fairly be said to support an interpretation that oil "produced and sold but then repurchased and used on the same lease" would be free of royalty assessment. Yet, absent such an interpretation, the requirement that royalty be assessed where oil is sold must attach by operation of the clear statutory language of 30 U.S.C. | 226(b)(2) (1982).

Moreover, to the extent that the above analysis is correct, it would also follow that Article 16.3 is not applicable since, as applied to the

Federal royalty interest, it would conflict with the relevant statutes and regulations and would, therefore, be expressly excepted by Article 16.4. We conclude, therefore, that the Director, MMS, was correct that, to the extent that oil was used to produce electricity which was then sold, royalty was properly assessed.

We recognize that this analysis may appear vulnerable to the criticism that it represents the triumph of form over substance. Thus, had Petro-Lewis elected to utilize the surplus energy output option, no sale of the electricity would have occurred and no royalty would have been assessed since all of the crude oil would have been used within the unit to enhance unit production and, under NTL-4A, such oil would be exempt from royalty payments.

But form has its own substance. There are myriad consequences attendant whenever certain choices are made, not all of them necessarily foreseeable. It is almost a certainty that appellant did not realize that, when it elected the net energy output option it was thereby rendering the oil needed to produce the electricity subject to royalty. Rather, it elected, for sound economic reasons, to opt for the net energy output option because a favorable price differential existed at that time between the "avoided costs of power" rate and the "industrial" rate. The problem, however, was that in order to avail itself of this favorable differential appellant sold the electricity to PG&E and then repurchased it. It is this act which triggered the requirement to pay royalties.

Appellant, in essence, seeks to have us treat the sale as a fiction. But it was not. The sale was a fact which, as one of its intended consequences, allowed appellant to avail itself of a favorable price differential. That it may have had a far more deleterious unanticipated consequence by rendering appellant liable for royalty payments does not justify ignoring the legal results which necessarily ensued upon the sale of the electricity to PG&E.

[2] There remains, however, the question of the proper basis upon which to assess royalty. Appellant objects to the netback procedure which MMS directed for calculating the royalty amount. Under this procedure, the royalty value per barrel of oil deemed to be used for production of cogenerated electricity is the total value of the electricity sold, less a processing allowance, divided by the total volume of oil burned for electricity generation. Petro-Lewis objects to this formula, arguing that:

> Instead of the value being based upon the total amount received by Petro-Lewis for cogenerated electricity sold to PG&E under the Power Purchase Agreement (less a processing cost) or the value of the oil had it been sold at the tank battery, whichever is greater, Petro-Lewis submits that the per barrel value of the oil deemed to be used to produce cogenerated electricity should be based solely upon the value of that oil as if it had been sold at the battery with other oil from the unit rather than the "netback" value.

(Statement of Reasons at 27).

Appellant's objection to the netback valuation is basically that a portion of the value of the electricity is derived from the manufacturing process when the crude oil is converted to steam and then electricity. Petro-Lewis argues that MMS has no right to the increased value resulting from this manufacturing process. In support of its position, appellant draws a comparison between its situation and that involved in the assess-ment of royalties for casing-head gasoline.

As early as 1926, the Department eschewed any claim that its royalty for casing-head gasoline (a manufactured product) should be based on the value of the finished product. See Operating Regulations to Govern the Production of Oil and Gas, 52 L.D. 1 (1926). The Department noted that "[t]he value of [casing-head gasoline] is contingent upon the value of the raw material and the cost of its manufacture. The Government does not wish to collect royalty on that part of the value which is derived from the cost of manufacturing, inasmuch as the Government's equity is confined to the value of the raw material involved." Id. at 11. Accordingly, the Department directed that two-thirds of the value of the casing-head gasoline would be royalty free, as an allowance for the cost of manufacture. That allowance has continued to this day. See 30 CFR 206.106.

The allowance for casing-head gasoline proceeds from the same theoretical basis that animates allowance for certain transportation and processing costs. Thus, while the Department has refused to allow a transportation deduction for costs incurred in transporting oil or gas to a selling point within the field, it has allowed reasonable transportation costs from the field to the first point of sale. Compare The Texas Co., 64 I.D. 76 (1957) with Kerr-McGee Corp., 22 IBLA 124 (1975). In the former situation, the cost of transporting oil or gas to a market within a field was deemed to be one of the ordinary incidents of lease operations (see The Texas Co., supra at 80), whereas in the latter, it has been deemed a post-production cost for which a deduction is properly allowed. See United States v. General Petroleum Corp., 73 F. Supp. 225 (S.D. Cal. 1946); Shell Oil Co., 70 I.D. 393 (1963).

Similarly, while the Department has held that costs encountered in placing oil or gas in a marketable condition are part of the costs of production and, hence, not deductible for royalty purposes (see The California Co., 66 I.D. 54 (1959), aff'd, 296 F.2d 384 (D.C. Cir. 1961)), the Department has also recognized that certain processing costs, which go beyond merely rendering the product marketable but rather further enhance its value, may be deducted from gross value. See, e.g., Black Butte Coal Co., 103 IBLA 145 (1988).

As we understand the decision of the Director, MMS, he recognized that some allowance was proper. Hence, the formula he adopted provided for the deduction of a processing allowance from the value of the electricity sold. The point at controversy herein is the fact that, because the formula of the Director starts with the value of the electricity sold and then subtracts processing costs, the remaining value base upon which royalty will be assessed includes any profit attributable to the electric generation facility.

The decision of the Director, MMS, did not address this contention regarding the netback procedure. 5/ However, counsel for MMS has directly confronted appellant's contention in its submission to the Board, by making two points. First, it points out that 30 CFR 206.103 expressly provides, in relevant part, that

> [u]nder no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary.

According to MMS, this regulation did not merely permit a reference to the value of the electricity sold, it required it. That value constituted the "gross proceeds" obtained by Petro-Lewis.

Second, MMS points to Federal court decisions, most notably Marathon Oil Co. v. United States, 604 F. Supp. 1375 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), as recognizing the netback procedure as "fully valid and consistent with the MMS regulation" (Answer at 17). Thus, it is contended that the decision of the Director, MMS, should be sustained. We agree that the decision in Marathon is of particular relevance to the question under examination, but are of the opinion that the Marathon decision substantially undermines, rather than supports, the arguments advanced by MMS.

5/ Indeed, appellant did not make this argument to the Director, MMS. Rather, it asserted that the royalty value calculation should be based on the difference between the proceeds it received for the sale of electricity to PG&E and the amounts which it paid to repurchase the electricity. The Director rejected this contention.

To put the Marathon decision in perspective, it is necessary to briefly recount the salient facts. Marathon owned an undivided 50-percent working interest in various leases in the Kenai Field Unit in Alaska which had been producing natural gas since 1961. A portion of Marathon's allocated production was delivered to a liquefied natural gas (LNG) plant which it owned. The delivered gas was cooled through a multi-step cooling process and transformed into a liquid. The liquefied natural gas was then shipped to Japan, where it was sold.

Commencing in 1977, a dispute arose between the Geological Survey (which at that time was responsible for the management of producing Federal oil and gas leases) and Marathon as to the proper computation of royalty owed to the United States. Suffice it for our purposes to note that ultimately MMS directed Marathon to pay royalties based on the sales price which it received in Japan, less expenses, i.e., on a netback basis, which resulted in a substantially higher royalty assessment. Marathon refused to pay at the increased rate and, after receiving various orders from MMS requiring it to do so, sought declaratory relief from the United States District Court for Alaska.

In his decision, Judge Fitzgerald reviewed the applicable statutes and regulations, particularly 30 CFR 206.103, and expressly held that "the net back method was necessary to satisfy the gross proceeds requirement." 604 F. Supp at 1385. However, a close analysis of Judge Fitzgerald's reasoning discloses that MMS' reliance on his decision in the present appeal is totally misplaced.

First of all, Judge Fitzgerald pointed out that, in attempting to ascertain a reasonable value of the LNG being sold to Japan, MMS was forced "to look at the landed price in Japan and work back to arrive at a reasonable wellhead value." Judge Fitzgerald continued, "To do this, MMS pro-posed to make allowances for costs of liquefaction and transportation, and for a reasonable rate of return on the LNG plant. Deducting these allowances from the sales price in Japan would thus yield an estimated wellhead value for the gas." Id. (emphasis supplied). In effect, by allowing a reasonable rate of return to be deducted from the gross proceeds, MMS was eschewing a royalty assessment on the profits derived from the manufacture of the LNG. 6/

This is the precise point made by Petro-Lewis in the instant appeal, viz., MMS should not be permitted to assess royalty on profits derived from the processing of the crude oil into electricity, yet, by its computation method, MMS was essentially seeking a royalty upon the profits attributable to the cogeneration facility. We believe appellant's point is well taken. Even if the netback approach were applicable in the instant case, the decision of the Director, MMS, would have to be set aside since a review of the costs allowed appellant fails to disclose that any deduction was permitted for a reasonable rate of profit from the cogeneration facility. 7/

6/ In this regard, it is interesting to note that in its appeal before the Ninth Circuit, Marathon argued that the 8-percent rate of return which MMS allowed was arbitrary and capricious. The court, however, held that this question was not ripe for judicial review since the district court had retained jurisdiction to conduct an accounting to determine the royalties due from Marathon. 807 F.2d at 766.

7/ Thus, a review of the documents appended to the June 27, 1985, decision of the Chief, Royalty Valuation and Standards Division, discloses that

More critically, to the extent that the MMS approach is based on an attempt to netback from the value of the electricity sold, Judge Fitzgerald's analysis clearly establishes that it is improper. One of the arguments which Marathon made before the District Court was that the Director, MMS, is required to establish the reasonable value of production. Marathon argued that the LNG it sold in Japan was a manufactured product distinct from the natural gas produced at the wellhead and, therefore, MMS could not derive the value of the natural gas from the price paid for the LNG. While Judge Fitzgerald rejected this contention, he did so on a basis critical to the determination of the instant appeal. He noted:

> I am not persuaded [by Marathon's argument]. LNG is natural gas that has been cooled for purposes of storage or shipment. There is no alteration of the chemical properties of the gas. Regardless of whether liquefaction is termed "processing" or "manufacturing," the fact remains that the LNG delivered in Japan is chemically identical to the natural gas at the lease. Therefore, MMS did not violate the regulation when it directed that the royalty basis for the gas be derived from the sales price of the LNG in Japan. [Footnote omitted.]

Id. at 1386.

Applying this analysis to the facts of the instant case, it immediately becomes clear that, unlike the situation in Marathon, the crude oil produced and the electricity from which the netback procedure attempts to derive the value of the crude are inherently different substances. Even granting the

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fn. 7 (continued)
the allowance permitted Petro-Lewis was based solely on costs absorbed in generating electricity. There is no indication that any allowance was made for profits derived from the process.

argument that MMS must base its valuation on "gross proceeds," the question which still must be answered is "gross proceeds" of what?

The position which MMS has taken in this case ignores the fact that the first sentence of 30 CFR 206.103 grants it the authority to establish the "reasonable value of the product." (Emphasis supplied.) Furthermore, the gross proceeds referred to in the regulation are those "accruing to the lessee from the sale thereof." The product involved herein was crude oil. There are no "gross proceeds" from the sale of that product because there was no sale of crude oil. Rather, appellant converted the product to its own use when producing steam which was then used to produce the electricity it sold. As we noted above, royalty is properly due on the crude oil so consumed. However, we agree with appellant that the royalty therefor should be assessed against the value of that portion of the oil produced from the North Kern Front Field Unit, used for production of energy, in the form of steam, which was expended in the generation of electrical energy, and not on the value of the electricity which was generated. 8/ Therefore, to the extent that the decision of the Director, MMS, required the computation of royalty owed based on the netback method, it is reversed.

8/ In this regard, it is useful to keep in mind the fact that the United States always reserves the right to take its royalty in-kind. Had the United States elected to do so in the instant case, it would have received one-eighth of the crude oil attributable to the production of electricity. The cogeneration process Petro-Lewis used was not performed to upgrade the crude oil so as to make it marketable. Rather, the crude oil which the United States would receive would be in the exact same condition as that which Petro-Lewis was using to fire its steam generators and, indeed, the United States would be able to so use the crude without further alteration of the oil. A royalty based on value of the crude oil at the lease is the economic equivalent of the value of the royalty oil. By valuing the oil appellant consumed in the generation of energy in the form of steam which was then used to produce electricity, the United States is receiving all to which it is fairly entitled.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision of the

Director, Minerals Management Service, is affirmed in part and reversed and remanded in part.

James L. Burski
Administrative Judge

I concur:

R. W. Mullen
Administrative Judge